THREE GOLDEN RULES

FOR THE INVESTOR SEEKING SAFETY OF CAPITAL CERTAINTY OF INCOME AND PEACE OF MIND

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WITH AN INTRODUCTION BY

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TO PART WITH GOOD MONEY in exchange for stocks and shares or any other kind of property is not necessarily an investment. Sometimes it is a mere gamble, sometimes an act of pure folly.

Investment, in the proper sense of the word, means an exchange of money for securities with more than a reasonable expectation of being able to get one's money back at any time, if wanted, by a re-sale of the securities bought and with a sure prospect of receiving, in the meantime, a steady income in return for the use of one's money.

How is the ordinary man or woman to distinguish, among the mass of securities which are available on the Stock Exchange, between the safe and the speculative, between the good and the bad?

Is it possible to treat the investment of money as if it were an exact science and to formulate definite rules

for the guidance of the investing public, or is all investment just a blind gamble in which the blanks are much more plentiful than the prizes?

In my view, it is possible to formulate certain plain principles, the observance of which ought to guarantee the investor safety of capital, certainty of income and peace of mind.

This essay is an attempt to set out those principles.

C.A.M.

ONCE a comparatively simple matter, the problem of investment has of late been complicated by the enormous growth in the number of securities available; in other words, by the increased quantity of pitfalls that are spread before the feet of the unwary.

Moreover, a new danger has arisen, or one which, if not new, affected our forbears to so slight an extent that they hardly needed to consider it; namely, the danger involved by violent fluctuations in the value of money and, consequently, in the price of commodities and in the cost of living—fluctuations which may impoverish even those investors whose choice of securities would have been most judicious and successful if only the value of money had remained stable. The pound sterling has suffered some disconcerting variations in value in recent years.

To our Victorian ancestors the problem seemed

simple, at least for those investors who looked, as all sensible investors should, to safety first, safety second and safety all the time as the ideal to be aimed at. British Government stocks gave them a peaceful haven for their savings, in which they found, for the best part of half a century, the certainty of a steady if somewhat niggardly rate of interest and also the certainty of being able to realize at prices which fluctuated within narrow limits, if the holding had to be turned into cash.

In those days the Chancellors of the Exchequer applied their "abhorred shears" to our incomes with moderation, content to take from us only pennies where they now take shillings, and, though the cost of living fluctuated, it did so to an extent that was almost negligible as compared with its mercurial behaviour in recent years.

Such pleasant stable conditions being a thing of the past, it has become necessary for intelligent people to give much more careful attention to the question of what to do with their savings. The plain and simple rule of Victorian days that prudent investors should stick to Government securities, with perhaps a sprinkling of first-class railway and industrial debentures

and preference shares, has fallen into disrepute. When the great war came, and holders of Consols, bought, it may be, at prices well above par, saw them fall to 50, and all securities with a fixed rate of interest following them in their headlong course, confidence in Government stocks as a certain "store of value" was wrecked. Moreover the income they provided, however punctually it might be paid, had no longer the same purchasing power, while at the same time the tax-gatherer was taking more of it and leaving less. And so those who had played for what they hoped was safety had reason to envy those of their neighbours who had followed a line that was once regarded as speculative and unsafe and had put their money into the ordinary shares of industrial undertakings. While the investor in Consols had lost perhaps half his capital, those who had risked their money in the shares of shipping, coal, iron and steel and other more speculative enterprises had, out of the greatest economic disaster of our times, made enormous if transient profits. Clearly the old principles of investment had to be revised and the merits of ordinary shares reconsidered.

And then there appeared an exponent of a new investment doctrine, according to which ordinary shares,

if carefully selected and widely diversified, are at all times the safest holding for investors in search of increasing income and improving capital values. The teacher of this new doctrine, so directly opposed to the creed of a former generation, was Mr E. L. Smith, an American investment expert who published in 1924 a book called *Common Stocks as Long-Term Investments*, in which he demonstrated the superior merits of common stocks, or ordinary shares as we more usually call them on this side of the Atlantic, as compared with "high-grade bonds" by which he meant the fixed-interest first charges on the great American railroads and industrial companies.

His conclusions were all the more interesting because he frankly admitted that he had been led to these conclusions in trying to establish a principle that proved to be incorrect. He had believed that though ordinary shares were the best securities to hold during periods in which the prices of goods were rising, fixed-rate securities must be best when a fall in commodity prices was in progress—in other words, when the value of money is rising. Setting out to prove this theory by the test of practical experience, he found himself contradicted by the result of his investigations

which showed the superiority of ordinary shares at all times, whatever may be happening to money values or commodity prices.

He carried out his investigations by tracing the history, over various periods in America's tempestuous economic life, of a certain sum invested in common stocks, as compared with the history of a similar sum invested in first-rate fixed-interest bearing stocks. In order to escape the charge of 'jobbing backwards' as they say on the stock exchange, that is of selecting common stocks that had behaved in a manner that would support his theory, he made up his list of stocks on some purely mechanical principle, such as the stocks which had the largest amounts in issue or the stocks which were most actively dealt in. The details of the results that emerged from his widely varying tests are well worth studying.

Here it need only be said that, though the amazing ups and downs of American prosperity and depressions produced their inevitable effects on the fortunes of the imaginary investor whose experience Mr Smith was following, common stocks came through the ordeal with triumphant, if not quite invariable, success. He had certainly shown that, judged by past perform-

ances through times of wild disturbance, common stocks were by no means speculative ventures to be regarded with suspicion by the prudent but a very satisfactory medium of investment for those in search of rising incomes and capital appreciation.

What is, perhaps, even more important for our present purpose, he not only showed that ordinary shares, if the right shares are selected, may be the safest form of investment, but he also discovered and set forth the reason why we may expect them to be so. This is the fact that in all well-managed and successful companies the directors never distribute in dividends the whole of the profits, but always put away some part of the profits and add them to the reserve funds or invest them in extensions and development of the business.

Whichever practice be followed—whether the undivided profits are invested separately or added to the working capital of the enterprise, they will, if judiciously employed, increase the revenue of the company in the future—and so the result of this policy is that holders of ordinary shares in such companies continually have part of their incomes reinvested for them by the directors to accumulate at compound interest, and may consequently expect with confidence that profits

and dividends will presently and inevitably expand and the market value of their holding increase.

As to the truth of the theory that the magic of compound interest is working all the time in favour of the holder of ordinary shares in well-managed companies there can be no doubt that Mr Smith proved his case. But it was easy to object, when examining the tests he made and their results, that they were all based on the experience of America and taken from a period in which the material progress of that country was proceeding at a pace quite unexampled in economic history, a period when Britain and Europe were pouring emigrants and capital into the United States and its inhabitants were devoting themselves with a wholehearted energy hardly to be seen elsewhere to the business of developing the immense resources of a land teeming with nearly every gift that Nature can, in her most generous mood, lavish on men engaged in the pursuit of wealth.

For these reasons, a similar test applied to the history of securities in Britain was obviously wanted, and it was soon supplied by Mr H. E. Raynes, a Fellow of the Institute of Actuaries, who in 1928 presented his colleagues with a memorandum on the *Place of Ordin-*

ary Shares in the Investment of the Funds of Insurance Companies. British insurance companies have long been famed for prudence and success in investment, and one felt that when this problem was tackled by the Institute of Actuaries a really authoritative pronouncement would be produced.

Working along the same lines as Mr Smith and tracing the course of investments in ordinary shares and fixed-interest stocks during the fifteen-year period from 1912 to 1927, which covered the war and the after-war boom and slump, the general strike and the coal strike of 1926, Mr Raynes again found that the advantage was, in the aggregate, strongly in favour of the holder of ordinary shares. In one or two points his investigation might have been simplified and made more telling. He gave the incomes derived from his two classes of investment after deduction of income tax which had, of course, varied considerably during the period examined and so made his results less clear.

He compared the yield on ordinary shares not with that derived from fixed-interest stocks in general but with that derived from the fixed-interest stocks of the same companies. This last arrangement had the most unfortunate effect of leaving out of his calculations the

shares of banking and insurance companies, as these companies seldom raise any part of their capital in the form of fixed-interest securities, and to leave out the banks and insurance companies was to leave out a group of companies which are conspicuous examples of the benefits conferred on shareholders by a policy of allocating persistently a high proportion of profits to reserves.

Moreover, it might be objected by a captious critic that the period chosen by Mr Raynes was likely to be favourable to ordinary shareholders owing, in the first place, to the huge profits made in many branches of industry during and just after the war and, in the second place, to the enormous addition that was made, through wartime borrowing, to the volume of fixed-interest stocks, tending to reduce their current price. Nevertheless, when all that can be said by way of criticism is said, Mr Raynes' investigation must be accepted as a surprisingly emphatic endorsement of the conclusions reached by Mr Smith working in the light of American conditions.

WE HAVE SEEN that both Mr Smith and Mr Raynes arrived at their conclusions as to the investment merits of ordinary shares by investigating lists of securities compiled in some arbitrary way. Evidently they had to do so, for to pick and choose their securities would have laid them open to the suspicion of having chosen them with a view to proving their case.

But it is obvious that no sensible investor would choose securities for investment by any such mechanical method and that carefully selected shares—if the right rules for selection can be found—should lead to results very much more favourable to the investor.

On what principles is the investor to select? How is he to choose among the bewildering variety of ordinary stocks and shares at his disposal?

The first rule to be applied has already been pro-

vided for us by Mr Smith in the key he discovered to the advantages possessed by common stocks. This he found in the fact that the value of the ordinary share capital in well-managed companies is automatically increased year by year by the allocation of profits to reserves, because good Boards of Directors never divide the profits of their companies up to the hilt but keep back part to be applied to future development and expansion, with the result that dividends of companies so managed tend to show a steady increase, reflected in the market value of their shares.

The record of the Imperial Tobacco Co. (of Great Britain and Ireland) is one of the best examples of this sound policy. This great company annually places to reserve substantial sums varying from 5 per cent. to 10 per cent. of the net profits. The retention of these reserve funds in the business has undoubtedly added materially to earning power. It has enabled the directors to distribute, periodically, valuable capital bonuses to the fortunate shareholders. As a result, original investors have enjoyed a steadily rising income and their present-day holdings are many times more valuable than their initial investment.

Rule the First is, therefore, already laid down for us.

CHOOSE THE ORDINARY SHARES OF COMPANIES WHICH SHOW THE BEST RECORD IN THE REGULAR ALLOCATION OF PROFITS TO RESERVES.

This Rule has been placed first because of its supreme importance. It is the regular allocation of profits to reserves that breathes life into the ordinary share capital of a company. Loan capital is frozen capital, incapable of growth, but ordinary share capital should be a living thing which grows naturally in value, if the business of the company is properly conducted.

The only kind of capital that is really safe is capital that is being built up and increased, year after year, by additions to reserves.

But nothing the directors can do will suffice to keep a company going if there is no longer a demand for the commodity or service that it supplies. Sound principles as to the division of profits are not much use if the profits divisible are a vanishing quantity, and so we see that another essential must be the widest possible market for the products or services of the company in which we propose to invest, and, as far as it is possible

to foresee, the certainty that that market is going to last.

This is not perhaps as easy as it sounds. The investor who, before the war, placed his savings in the shares of British shipping companies was apparently conforming fully to this rule. World trade was steadily increasing, the British Mercantile Marine was the finest in the world and there was nothing to take the place of ships for overseas transport. But in the past fifteen years there has been an almost unbelievable change. The growth of economic nationalism has greatly reduced the volume and value of world trade and has encouraged many nations which formerly employed British ships to build and operate their own fleets. Supply now far exceeds demand, freights are no longer remunerative.

The experience over the past twenty-five years of investors in home rails or Lancashire textile shares has been equally unfortunate, though in pre-war days, these three industries—shipping, cotton and railways—were rightly regarded as the solid foundations on which the prosperity of the whole country was based.

The task of the investor is therefore going to be more difficult when he comes to consider Rule the Second.

CHOOSE COMPANIES WITH A WIDE AND PERMANENT MARKET FOR THEIR PRODUCTS OR SERVICES.

The third essential is good management, without which the freest possible markets and the severest austerity in the division of profits will effect nothing for the shareholders. For, unless the management is right, able to judge exactly what kind of commodity to provide and how to provide it and how to get it to the notice and into the hands of consumers and how to do all these things at once, most cheaply and most efficiently, in these times of acute competition, dwindling sales will soon begin to tell their tale.

To the average investor this question of management is, perhaps, the most difficult of all on which to form an opinion. How, for example, is a country doctor, living in the southern counties, to satisfy himself that, say, a steel company with works at the other end of the country enjoys first-class management? Management is so essentially personal that it is extremely difficult for anyone not closely connected with a particular company or industry to be well informed at all times on this point. Broadly speaking, the only

test of good management available to the ordinary investor is the record of results achieved over a substantial period of years. Companies which have a long record of profits earned and dividends paid may be assumed to have solved the problem of management.

And so we come to Rule the Third.

CHOOSE COMPANIES WITH A LONG RECORD OF DIVIDENDS REGULARLY PAID.

What companies, or groups of companies, can we find which will past the tests imposed by these three rules?

So far as industrial companies generally are concerned, it must be recognised at once that for one which fulfils all these requirements, there are many that do not. Changing methods of production, changes in public taste and the never-ceasing pressure of competition make all industrial concerns, to some extent, hazardous.

It is in the field of finance, in the shares of banking and insurance companies, that we can make reasonably sure of finding what we want.

No other group of industries covers so wide a field of operations or supplies a demand which is so persistent and so certain to persist, so long as our present economic system survives. Every business concern, whether private or public, whether a tiny one-man show or a gigantic commercial combine, must have a banking account, is almost certainly in need of credit from time to time, and is bound to protect itself by insurance against all the countless risks to life and property involved in production, transport, storage and sale.

As regards the demand for their services therefore, banks and insurance companies are in a particularly favourable position which is unlikely to be altered for as long time ahead as one cares to look.

To these great undertakings, good management is all important, and they have, during a century of unbroken progress, acquired a store of experience and tradition that enables them to train their officers with exceptional facility.

Banks and insurance companies also fulfil all the requirements of the first Rule to a greater extent than any other industry. It is common knowledge that no bank or insurance company ever writes up the book

value of an asset if it happens to appreciate, but that full provision is made out of profits for any depreciation, even if only of a temporary nature. In fact, these great institutions habitually over-estimate their liabilities and under-estimate their assets. From the distributable profits thus cautiously arrived at, further allocations are made to the disclosed reserves and only a relatively small proportion of the actual profits are distributed as dividends. The balance, of course, is retained in the business and adds to the constantly growing value of the equity.

No one outside the sacred precincts of the bank parlours has any idea of the actual proportion of bank profits placed to reserves, but it is obviously large. In the case of insurance companies, the accounts show that some of the strongest companies pay their dividends wholly out of their interest receipts and so add their entire annual trading profits to reserves. In the aggregate, 85 per cent. of the 1935 dividends of the twenty-five leading companies was paid out of interest receipts. No other industry and, indeed, no individual company of any kind can approach this excellent record.

IT WILL BE SEEN, therefore, that bank and insurance shares conform admirably to our three rules. Until recently, however, they were generally regarded as rich men's investments because of two disadvantages: their high market values and the liability in respect of uncalled capital attaching to many of the shares.

Investors, no matter how modest their means, should never be deterred from buying a share merely because it stands at what seems a high price. In investment, as in everyday life, it usually pays to buy the best. In any case, a share of £1 standing at £5 is no dearer than a 1s. share standing at 5*s*. Nine times out of ten results will prove it to be decidedly cheaper.

The liability in respect of uncalled capital, is perhaps, the greater disadvantage in the eyes of the public. It is not generally realized that partly-paid shares date back to the very early days of company finance

when conditions were very different from those ruling to-day. A century of sound finance has placed the banks and insurance companies in positions of such impregnable strength that not even the financial and economic upheavals of the War and the post-war period could affect their continued progress. It is impossible to conceive circumstances under which these great concerns would be forced to make a call in cash upon their shareholders. If events ever came to such a pass it would not matter what the investor held—all securities would be equally worthless. It is much more likely that in the future, as in the past, uncalled liabilities on shares will be reduced or extinguished by processes involving no payment on the part of the shareholders. The most recent example was provided by the North British and Mercantile Insurance Company, which utilised over £1,000,000 of its reserves for this purpose.

In any case, the disadvantages of high market prices or uncalled liabilities may now be avoided by investing through the medium of the various trusts of bank shares and of insurance shares, particulars of which can be obtained from any stockbroker.

WE HAVE, THEREFORE, ARRIVED at a practical solution of the investment problem. We secure safety of capital and certainty of income by confining our investments to the ordinary shares of companies whose conservative methods of distributing profits make a gradual increase in their dividends and a corresponding gradual increase in the capital value of their shares, if not mathematically certain, as certain as anything can be in this uncertain world; companies whose good management is evidenced by a long record of profits regularly earned and dividends regularly paid; companies whose services are in constant demand; and we find in the banks and insurance companies of Great Britain, a group of companies which fulfils these requirements to the letter, the most consistently successful and well-managed group of companies in the world.

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METHODS OF INVESTMENT IN BANK SHARES AND INSURANCE SHARES

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THE
TRUST OF INSURANCE SHARES*
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offer to the investor a participation, free from personal liability in respect of uncalled capital, in carefully selected portfolios of
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The investments held by the Trust of Insurance Shares are selected from the stock or shares of the following

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Alliance
Atlas
Britannic
Caledonian
Commercial Union
Eagle Star
Economic
Employers' Liability
Equity and Law
General Accident
Gresham
Guardian
Legal and General
Life Ass. of Scotland
London
Lond. & Manchester
London & Lancs.
N. British & Mercan-
[tile
Northern
Pearl
Phœnix
Prudential
Royal Exchange
Royal
Scottish Life
Scottish Union
Sea
Sun
Sun Life
World Auxiliary
Yorkshire

The investments held by the Trust of Bank & Insurance Shares are selected from the stock or shares of the following companies:

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Barclays	Martin's
Lloyds	National
Midland	Barclays (D.C.&O.)
National Provincial	Bank of Australasia
Westminster	Bank of Montreal
District	Dominion

Bank of New Zealand
Royal Bank of Canada
National Bank of India
Royal Bank of Scotland
Union Bank of Scotland
Mercantile Bank of India
Standard Bank of South Africa
English, Scottish & Australian Bank
Chartered Bank of India, Australia & China
Hongkong & Shanghai Banking Corporation

DISCOUNT COMPANIES

Alexanders National Union

INSURANCE COMPANIES

Alliance	London
Atlas	Northern
Beacon	Pearl
Britannic	Phœnix
Commercial Union	Planet
Eagle Star	Prudential
Equity and Law	Royal Exchange
General Accident	Royal
Guardian	Sun Life
Legal and General	Yorkshire

London and Lancashire
London and Manchester
North British & Mercantile
Scottish Union and National
Union Insurance Society of Canton

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The investments held by the Trust of Bank Shares are selected from the stock or shares of the following companies:

Bank of England; Bank of Scotland; Barclays; Lloyds; Midland; Nat. Provincial; Westminster; District; Martin's; Hambros; Royal Bank of Scotland; Union B. of Scotland; The National; Barclays (D.C. & O.); Bank of Australasia; Bank of New South Wales; English, Scottish & Australian Bank; National B. of Australasia; Union B. of Australia; B. of New Zealand; National Bank of New Zealand; Chartered B. of India, Australia & China; Eastern Bank; Hongkong & Shanghai Banking Corporation; National B. of India; Mercantile B. of India; Royal Bank of Canada; Bank of Montreal; B. of Nova Scotia; Canadian B. of Commerce; Dominion B.; Standard B. of South Africa; B. of British W. Africa; Nat. B. of Egypt; Imperial B. of Iran; B. of London & S. America; Anglo-Palestine B.; Alexanders Discount Co.; National Discount Co.; Union Discount Co. of London.

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